Research Department
Federal Reserve
Bank of
San Francisco

July 30, 1982

FRBSF Weekly Letter

Corporate Liquidity

One of the unusual aspects of this recession has been an increase in short-term corporate debt and a corresponding decrease in corporate liquidity. Because this has occurred at a time of high short-term interest rates, it has put extraordinary pressures on corporations and added to the business cycle risks they already face.

Typically, in a business cycle recession, long-term interest rates fall and corporations respond by shifting borrowings out of the short-term market into the long-term market to lock in longer maturity debt and to increase corporate liquidity. This has not happened in the 1980-1982 period of double-dip recession because long-term interest rates, instead of falling, have actually risen, from an average of 9 percent in 1979 to an average of 14 percent in 1982. At the same time, the ability of the long-term bond market to absorb corporate borrowing has shrunk. Less than a third of the volume of new issues has appeared in the first half of 1982 as compared to the average of 1980. These two elements combined have increased the dependence of corporations on short-term financing and undermined their liquidity positions.

As shown in Chart 1, the distribution of business cycle risk, while higher in the last two years, is uneven. Aaa-rated corporations have had an increase in risks relative to the late 1970's but the increased risks are actually lower than in the early to mid-70's. On the other hand, Baa-rated corporations have had an extraordinary rise in the amount of perceived business cycle risks in the last two years. The best managed and best positioned corporations have not suffered an extraordinary increase in risk as perceived by the financial markets but the less well-positioned corporations have.

The problem of corporate illiquidity is ultimately due to the government deficit. It is the major factor behind rises in long-term rates and thus the extraordinary dependence of corporations on short-term financing. The deficit raises long-term rates and reduces the volume of long-term corporate financing by its secular nature, which produces uncertainty about future credit demands, by the way it is perceived to affect future monetary policy and by the way the U.S. Treasury manages its borrowing.

Secular deficits

In the past, the government deficit was a temporary business cycle phenomenon, but the current deficit is secular, i.e., structural and permanent. This is illustrated in Chart 2. In past business cycle recessions, the progressive income tax structure ensured that the decline in tax receipts was proportionately greater than the decline in GNP, so deficits grew. However, because recession-induced declines in business credit demand exceeded increases in government demand for credit, interest rates fell. During business cycle expansions, tax receipts rose proportionately faster than increases in income, causing deficits to shrink. At the same time, private demand for credit grew faster than government demands for credit fell causing interest rates to rise. As both were induced by the business-cycle, deficits and interest rates moved in opposite directions.

Now that the deficit is secular, deficits and interest rates can be expected to move together. Two forecasts for deficits are shown through fiscal 1985 in Chart 2. An "optimistic" Administration forecast is that the deficit will be 3½ to 4 percent of GNP for the next five years. The "pessimistic" Congressional budget office forecast, which closely parallels private forecasts, is that the deficit will be in the 5½- to 6-percent range for the next five years. Although both forecasts assume vigorous growth in economic activity, the deficits are not expected to decline largely because the major tax cuts enacted last year had an effect analogous to reducing the progressive

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nature of the tax structure. Tax receipts will rise only about in line with the growth in national income. With government spending expected to grow at about this same rate, the deficits are not expected to decline in the next business cycle upswing.

Long-term uncertainty The existence of secular deficits has created great uncertainty in financial markets about future demands for credit. If private demands for credit rise with the business cycle expansion and government demand for credit does not fall, then total credit demand will exceed the national savings rate and crowd out some private spending. How much crowding out will occur depends upon the size of the deficit, which, as indicated in Chart 2, is highly uncertain. Forward looking financial market participants facing this degree of uncertainty about the future have shifted to the short-end of the market where uncertainty is much less of a problem. This is a key reason for the drying up of savings otherwise available in the long-end of the market.

Inflation risk Secular government deficits over the next five years also create great concern that the Federal Reserve will eventually be forced to monetize the deficits through increased growth in the money supply.

As shown in the *Weekly Letter* of May 21, 1982, the annual rate of growth in the money supply and the national debt has been fairly closely related since World War II. Since the change in the Fed's operating procedures in October 1979, that relationship has broken down as the growth in the national debt has accelerated while the growth of the money supply has decelerated. However, there is serious concern that the Fed will monetize some share of the 10 to 15 percent growth in the national debt that is expected to occur in each of the next five years. Full monetization could suggest as much as 15 percent annual growth in the money supply. The Federal Reserve, resisting monetization, could suggest annual growth of the money supply of 5 percent or less for the next five years. These policies represent sharply divergent views about the future rates of inflation and consequently current inflation premiums in long-term bond rates. In addition, the risk and uncertainty about the course of monetary policy over the next five years created by secular deficits adds an inflation *risk* premium to long rates even when the current inflation rate is declining. Markets remember that the sharp decline in inflation in 1975-76 was temporary as easy money in subsequent years led to another round of double digit inflation.

Debt management

The debt management policy of the U.S. Treasury has also impaired private corporate access to long-term funds. From 1976-1981 the U.S. Treasury has increased the average maturity of the national debt by more than 50 percent, from 2.6 to 4 years. If this trend is not reversed, an increasing share of larger future deficits will be financed at the long-term end of the market.

Despite the announced Administration policy to reduce inflation, the Treasury continues to lengthen the maturity of the national debt. Financing the deficit in the long-term market means the Treasury will be repaying debts with future dollars which have greater value than had previously been expected. With current high long-term interest rates based at least partially on market concerns that the inflation rate will not decline as planned, this policy increases the real burden of financing the national debt. The least-cost way would be to shift financing to the short-end of the market. While short rates are as high as long rates now, the possibility of rolling over the debt in the future, when the Administration's lower inflation forecast is realized and reflected in lower interest rates, would reduce the future financing burden.

Policy solutions

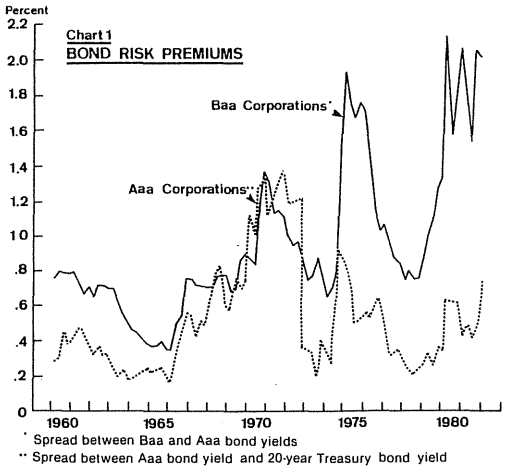
Fiscal policy can reduce the expected size of the deficit over the coming years by a combination of tax increases and spending decreases. This is essentially a political problem

with which Congress and the Administration are now grappling. The Federal Reserve can ease the liquidity strains on corporations only by increasing the supply of real money, i.e. the nominal money supply adjusted for inflation. If money and inflation are growing at the same rate, the real money supply is unchanged and corporate liquidity is not increased in any real sense. The supply of real money can be increased in one of two ways: first, by an increase in the rate of growth of the nominal money supply in excess of the inflation rate; and second, by reducing the inflation rate below the growth in the nominal money supply.

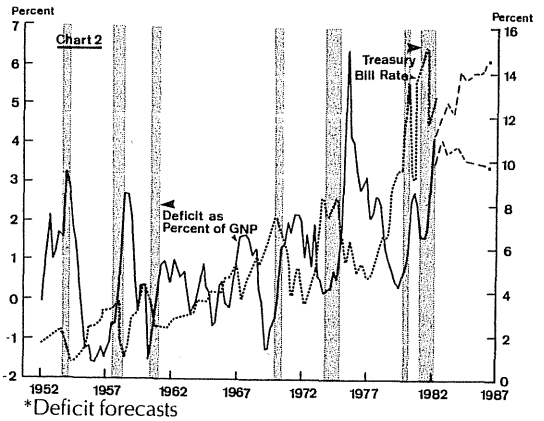
In the current environment, there is pressure on the Fed to choose the first of these alternatives: raise the nominal money supply. There are, however, two problems with this solution. First, it is only a short-run fix in helping increase liquidity and lower short-term interest rates. It requires the nominal money supply to rise faster than the inflation rate, but because money affects inflation, that further requires an accelerating growth in money over time. This is ultimately self-defeating because inflation increases the cost of holding money and thus, induces people to hold less real money balances. Furthermore, double-digit inflation would re-emerge and cause the Fed eventually to reduce nominal money growth. Corporations and the financial system will then be forced into a tight money squeeze once again. Second, the method will do nothing to solve the fundamental financial problem of corporations—the inability to tap long-term funds. Raising the nominal money supply will raise the inflation rate in the future, and inflation expectations today and will either prevent long-term rates from falling or cause them to rise further. This, of course, means that the ability of the long-term markets to absorb corporate financing will remain impaired. Corporations will continue to be forced to turn to banks and other short-term sources of funds. They will continue to be subject to variations in short-term interest rates and they will continue to face the structural risk associated with illiquidity.

The second method of increasing real money by reducing inflation, while slow, can have a far more permanent effect. Because lower inflation reduces the cost of holding money, it will induce people to hold larger real money balances.

Michael W. Keran



* Spread between Baa and Aaa bond yields
** Spread between Aaa bond yield and 20-year Treasury bond yield



*Deficit forecasts
Shaded areas indicate recessions

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/14/82	Change from 7/7/82	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	159,882	− 580	9,459	6.3
Loans (gross, adjusted) — total #	139,479	− 537	10,203	7.9
Commercial and industrial	43,897	− 280	5,219	13.5
Real estate	57,057	86	3,683	6.9
Loans to individuals	23,391	− 1	567	2.5
Securities loans	2,246	60	656	41.3
U.S. Treasury securities*	6,615	30	415	6.7
Other securities*	13,788	− 73	− 1,159	− 7.8
Demand deposits — total#	39,863	−2,404	− 3,445	− 8.0
Demand deposits — adjusted	28,192	155	− 1,769	− 5.9
Savings deposits — total	30,624	− 526	234	0.1
Time deposits — total#	97,341	1,225	14,391	17.3
Individuals, part. & corp.	87,854	1,076	13,429	18.0
(Large negotiable CD's)	36,436	718	2,612	7.7

Weekly Averages of Daily Figures	Week ended 7/14/82	Week ended 7/7/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	55	97	80
Borrowings	10	50	56
Net free reserves (+)/Net borrowed(−)	45	47	24

* Excludes trading account securities.

Includes items not shown separately.

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